MICHIGAN HOUSE OF REPRESENTATIVES – COMMITTEE ON TECHNOLOGY & ENERGY

TESTIMONY OF PHILIP R. O'CONNOR, PH.D.

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Introduction

Mr. Chairman and members of the Committee, my name is Philip R. O'Connor[1] and I appreciate the opportunity to testify on the question of providing Michigan electricity customers with the opportunity to choose their electricity supplier. *(Cover Slide #1)*

While industrial, commercial and residential customers in Illinois, Ohio, Pennsylvania and most other states in the northeastern quadrant of the country can choose among competitive suppliers, Michigan's law limits competition to just 10% of load. The result is that in 2012 Michigan consumers were paying an average of about 2 cents per kWh above the regional market price, or 20%, amounting to something on the order of $1.8 billion in extra costs.[2]

In the mid-1980s, while serving as Illinois' chief utility regulator chairing the Illinois Commerce Commission (ICC), I became an early advocate of natural gas and electricity competition at the wholesale and retail levels. I recognized that traditional utility regulation, while once the right approach, had become unsuited to accommodating new technological, financial, economic conditions. At the same time, reliance on market forces was working well in other arenas such as telecommunications, natural gas, trucking railroads and airlines.

Electricity Customer Choice is the Standard in the World's Developed Economies

Electricity choice is not mysterious. Electricity choice has been operating perfectly well for over a decade in the United States and the rest of the developed world. (Slide #2) When there have been problems, those problems have been the result of flawed regulatory designs of half-measures that tend to distort the market and inhibit customers from full exercising choice.[3]

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[1] Philip R. O'Connor is President of PROactive Strategies, Inc., a public policy advisory firm in Chicago. Biographical material attached as Slide 18

[2] The data relied upon on this testimony are from the U.S. Energy Information Administration, the Michigan Public Service Commission, KEMA (a leading industry standardized data source), the Federal Energy Regulatory Commission (FERC) and the National Electric Reliability Corporation (NERC).

[3] The California "energy crisis" is now widely recognized as having been rooted in requirements that utilities buy supply in a day-ahead market and not allowed to hedge prices into the future. This market design provided opportunities for manipulation by certain market participants. In several others cases, price spikes occurred during the transition from utility default rates that had been frozen for as long as a decade to market prices based on very large single day procurements. These one-time price spikes have given way to rapidly falling prices.

In the late 1990s and early 2000s, a number of states, including Michigan, began to allow consumers to opt for market-price supplies of power from non-utility suppliers while continuing to use delivery services of their local, traditionally regulated utility. These consumers normally paid transition fees to the local utility to compensate them for over-market investments made in the past. This was the case in Michigan as well.

There has been a massive change in the electric industry.

- More than a dozen states have full electricity choice and several others have limits, such as Michigan. Together, they account for more than 40% of total U.S. electricity consumption. Most are in the upper quadrant of the country in close proximity to Michigan. *(Slide #3)*
- Since 2008, there has been 40% growth in the volume of electricity purchased under choice contracts, now accounting for about 20% all U.S. consumption. *(Slide #4)*
- Most large customers moved to choice early on. Residential customers are rapidly joining the migration in large numbers, many of them through municipal aggregation programs in their communities.
- Electricity customer choice is not unique to the United States. It is established public policy in most of the English-speaking world, including the UK, Australia and New Zealand and in the European Union.

With more than 600 million people in markets with evolving electricity choice policies, it is traditional vertical monopoly regulation that is fast-becoming the abnormal arrangement in the developed world.

Michigan's 2008 Limits on Choice Is at the Heart of Rising Rates

Prior to its enactment of customer choice in 2000, Michigan's electricity rates were routinely above the national average and had the second highest rates among the five Upper Midwest Industrialized states of Illinois, Indiana, Ohio, Michigan and Wisconsin. These states have much in common, compete with one another in various ways and represent a key point of reference for assessing Michigan's electricity position. *(Slide #5)*

Following the enactment of electricity industry restructuring in 2000, Michigan's rates promptly fell below the national average and improved in relation to the other Midwest states. Immediately after the 2008 reversal of customer choice, prices began to rise and are now back above the national average and the highest in the Midwest. Illinois had rates higher than those of Michigan prior to its 1997 enactment of customer choice. Its rates rapidly fell below the

national average. Unlike Michigan, Illinois stayed on course. Today, its rates remain well below the national average, are the second lowest in the Upper Midwest.

Illinois prices continue to fall. Just last week, ComEd, which serves the Chicago area and accounts for about 80% of all load in the state, filed new default rates for those residential and small business customer show do not choose a supplier or who do not participate in municipal aggregation programs. The energy supply costs fell from about 7 cents per kilowatt hour to about 5 cents per kilowatt hour. That is about a 30% reduction. Overall, since delivery makes up about one-third of the total monthly electricity bill, consumers on these default rates will see a 20% reduction.

"Demand Destruction" Is Not the Issue

Governor Snyder's November energy message attributes much of Michigan's price problem to recession-related load loss. However, Michigan's "demand destruction" has been little different than that experienced in the other Midwest states. *(Slide #6)*

The loss of load problem has been similar in the five states, but the price outcomes have been quite different. *(Slide #7)*

Electricity rates increase when demand falls only if a state chooses to have it that way. In 2008 Michigan chose to return to a regulatory mechanism that raises rates when demand falls. In the world of competitive markets of any kind, including in the wholesale electricity markets and in retail electricity market, prices moderate or fall when demand falls.

Since 2007, rates in the three Upper Midwest states with traditional monopoly regulation rates have risen by well over 20%: Wisconsin 22%, Indiana 27% and Michigan 29%. In Ohio, which only recently has begun to aggressively implement customer choice rates have risen 14%. In Illinois prices have risen less than one-half of one percent, far below inflation. Monopoly versus customer choice is the explanation. *(Slide #8)*

The Michigan Public Service Commission's recent report on the status of customer choice shows the same story of Michigan's serious deterioration in its relative residential and industrial price positions. *(Slides #9 & 10)*

Illinois situation is instructive. Prior to the implementation of choice, Illinois average prices were consistently higher than the national average. Afterwards, Illinois prices have been consistently lower than the national average. The value of Illinois's improved price position is so far on the order of $33 billion. *(Slide 11)*

Five Arguments against Customer Choice

As a regulator, consultant and electric industry practitioner, I probably heard every argument against allowing customers to choose their own electricity suppliers. (*Slide #12)* Claims that customer choice in electricity does not work, hurts customers, hurts utilities, raises prices higher than under regulation or endangers reliability are simply do not comport with the real life operation of competitive markets themselves.

Five main arguments against customer choice fail when tested against actual experience. *(Slide #13)*

1) *Customer Choice Does Not Work*

   Customer choice is operating in such nearby places as Illinois, Ohio, Pennsylvania, most New England states, New York, New Jersey and Maryland. Farther afield are fully competitive markets in Texas, Australia and New Zealand. Great Britain is competitive and there are varying degrees of customer choice in the European Union as the EU moves along on its agreed policy of as fully transparent, cross-border internal EU market that is fully competitive in electricity.

   Electricity customer choice is public policy for over 600 million consumers. Not only is choice working, it is becoming the norm. Denial of customer choice is becoming the aberration.

2) *Reliability Is at Risk under Customer Choice*

   The three key segments of the electrical system, generation, transmission and local distribution can all be measured for reliability performance. Opponents of customer choice, however, cannot point to a body of standard industry statistical data, projections or analyses by industry organizations or the government that can differentiate comparative reliability levels between customer choice and monopoly states or utilities.

   Transmission
   Michigan's transmission network is mainly owned and operated by a well-regarded and well managed independent company with no ownership in distribution or generation. Customer choice would have no impact on transmission reliability in Michigan and has not had any adverse impact anywhere else.

Distribution

Distribution networks in customer choice states and in traditional monopoly states are used by all customers irrespective of who they buy their power from. In customer choice states, rates for delivery services are set by regulators in alignment with the revenue needs of the delivery network. If anything, in traditional monopoly states, the setting of bundled rates by regulators that do not differentiate between delivery and supply raises the question of a utility with both sets of assets robbing Peter to pay Paul. There is no basis for thinking that investment in the delivery network is shortchanged in any way by customer choice in supply. Indeed, it may well be that once generation becomes competitive, wires companies are better able to focus on the quality of delivery without distraction of the supply business.

Generation

- Opponents of customer choice often claim that investors will not take the risk of funding generation capacity in competitive markets and that there will be power shortages. Again, actual experience and all available data argue to the contrary. *(Slide #14)*The nation's generation portfolio is already highly diversified, with 59% of all U.S. generating capacity owned by utilities and 41% being non-utility.
- The ownership diversity of generation varies considerably in states and regions. For example, in New England 97% of electricity production is from utility owned power plants whereas in the West North Central region, the Great Plains, utility owned plants account for 88% of production. In our own North Central region of Illinois, Indiana, Michigan, Ohio and Wisconsin it is roughly an even split.
- In most customer choice states, generation has sold by utilities or spun-off to generating affiliates. In Illinois, for example, 94% of all the electricity produced in the state in 2012 was from non-utility generation. Even in Michigan, non-utility generation contribution to production was 26% of kilowatt hours in 2012.
- An important measure of generation reliability is the summer resources reserve margin. Customarily, NERC uses a level on the order of 15% as a reference point. In the northeastern quadrant of the United States, there are four regional transmission organizations, , the Midwest Independent System Operator (MISO) to which Michigan's utilities belong, PJM which is the largest in the nation and more than twice the size of MISO, and the New York and New England independent system operators (ISOs). Unlike MISO, which has a mix of customer choice and traditional monopoly, the other three are almost entirely committed to customer choice and non-utility generation. MISO's 2012 margin was estimated by NERC at 28.7%, PJM's at 30.6%, NYISO's at 17.2% and ISO-NE at 26.9%.

- The claim that customer choice inhibits investment in power plants flies in the face of history. In Illinois, since the 1997 enactment of industry restructuring, well more than 11,600 MW of generation were added, more than 30% increase in nameplate capacity. That increase was accounted for almost entirely by non-utility investment. In Michigan, since 1997, capacity additions totaled 5,800 MW, with most of that accounted for by non-utility generation in just the few years following the enactment of Michigan's original restructuring law in 2000.[4]

Customer choice opponents may speculate that power plant investment in the future will be inhibited by customer choice. But that speculation has no support from actual historical patterns.

3) *Customers Who Stay with the Utility Will Pick up Extra Costs*

Critics of customer choice claim that when some customers replace utility supply with competitive priced power from the market then other customers will be left holding the bag paying higher prices to the utility. This is true only if it is decided by state policymakers that this is the way they want it.

Every state that has moved to competitive choice, including Michigan during its original customer choice period after the 2000 legislation, has dealt with this question. They have effectives protected those customers who continue to take utility supply. Measures have included rate freezes, market-priced utility supply and, importantly, transition payments to utilities for above-market stranded costs and investments.

Under Michigan's original customer choice program the state's utilities would receive transition cost payments from customers choosing alternative suppliers. Unfortunately, since the 2008 decision to limit choice to 10% of total load, Michigan utility rates have risen significantly. That is the result of a specific public policy decision that was urged on the Legislature by the state's utilities. If Michigan had stayed on course, the stranded cost compensation system would have handled the very issue that critics of choice now claim is a show-stopper. The problem of price risk for customers who stay with the utility has been successfully dealt with time and time again and there is no mystery how to do it.

[4] This calculation is based on U.S. Energy Information Administration data bases.

4) *Customer Choice Is Unfair to Utilities*

Fairness to utilities is a proper consideration. Utility investors have put their money to work to provide electricity services to customers and expect a fair return for the risk they have taken. What the opponents of competitive choice for Michigan electricity consumers seem to ignore is that utilities in restructured states have successfully made the transition to customer choice. Most are strong supporters of customer choice.

In customer choice states regulators set rates for monopoly delivery utilities that provide for a fair rate of return and proper recovery of expenses.

The real debate is about whether generation, which is an increasingly competitive business, should be treated as if it were still a monopoly limited by old technologies. Wholesale electricity in the United States is an almost fully competitive industry today and overseen as such by the Federal Energy Regulatory Commission (FERC). There are no technical, financial or customer protection foundations for preventing customers from accessing the competitive electricity supply market.

The opposition to choice by Michigan utilities is fueled primarily by the fact that they failed to promptly adjust to customer choice after the original legislation in 2000. Now, after collecting transition charges for stranded costs, their costs are above-market by a considerable margin.

The transition to customer choice can still be made and it would not take long if the proper policies were put in place. Michigan's utilities could once again be compensated for their over-market costs, if need be and customers could still exercise choice and save money.

5) *Renewables and Energy Efficiency Programs Are Disadvantaged under Choice*

Claims that might be made by opponents of customer choice that competition inhibits state-based renewable portfolio standards or energy efficiency programs fail the test of the realities on the ground in restructured states. *(Slide #15)*

The U.S. Energy Information Administration (USEIA) tracks states with renewable portfolio standards.[5] Included in the 31 regulatory jurisdictions with enforceable

[5] http://www.eia.gov/energy_in_brief/article/renewable_portfolio_standards.cfm

renewables portfolio standards are all 14 jurisdictions (13 states and District of Columbia)[6] with substantial customer choice programs. Interestingly, most states of the Deep South, where utility opposition to customer choice has been strongest, there are few RPS programs.

As for state energy efficiency programs, the story is somewhat similar as can be seen from the energy efficiency scorecard map from the American Council for and Energy Efficient Economy (ACEEE).[7] *(Slide #16)* Choice states turn in a strong performance on energy efficiency programs. I would maintain that accurate price signals help to make such programs more effective.

Once again, the warnings of opponents of customer choice that there will be negative consequences from competitive electricity supply fly in the face of actual experience.

Five Benefits of Electricity Customer Choice

The observable benefits of customer choice can be grouped into five categories. These benefits are all being borne out in the real world of the actual operation of customer choice. *(Slide #17)*

1) *Market Pricing and Price Signals*

There has been much focus on average price levels in the group of states that have customer choice and those that have adhered to traditional regulation.[8] One dimension of that research suggests that regulation has little long-run impact on average price levels since other factors predominate.

However, the same research also shows that between since 2008 and 2011, with a sluggish economy and the large price declines in natural gas due to shale gas supplies, rates have fallen 5% in the group of customer choice states while they have risen 7% in the traditional regulated monopoly group of states. This trend continued in 2012, with low gas prices flowing through quickly in competitive markets while under traditional monopoly regulation there is considerable lag.

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[6] CT, DC, DE, IL, MA, MD, ME, NH, NJ, NY, OH, PA, RI, TX

[7] http://aceee.org/sector/state-policy/scorecard

[8] See John L. Domagalski and Philip R. O'Connor, *Regulation and Relevancy: Assessing the Impact of Electricity Customer Choice. ElectricityPolic.com,* http://www.electricitypolicy.com/articles/5122-regulation-relevancy-assessing-the-impact-of-electricity-customer-choice and Kenneth Rose, *State Retail Electricity Markets: How Are They Performing So Far? ElectricityPolicy.com,* http://www.electricitypolicy.com/articles/4455-stateretailelectricitymarkets

In competitive markets, customers receive prompt and accurate price signals about the economic cost of production and the supply and demand situation. This is the case whether the price a customer is looking for is for a multi-year contract or for real-time pricing at hourly or even shorter durations. The most glaring flaw in traditional monopoly price-setting is that when there is oversupply, prices are forced upward while during shortages prices are held down and therefore convey false information to everyone in the system.

Competitive markets in electricity are able to price the many specific features of electricity service including capacity, variable costs such as fuel, ancillary and transmission services and even reductions in demands by customers. Traditional monopoly regulation usually produces bundled rates that are inherently incapable of informing people about the cost of any given aspect of service.

2) *Flexibility*

Customers who can choose their supplier can also choose contract terms that best suit their own usage patterns, operating conditions, financial plans and preferences, such as for a greater portion of renewables in their supply. They can contract for short or long periods and achieve levels of price certainty impossible in traditional monopoly regulation. In an era of economic uncertainty, business can set their energy budget for several years ahead. Or, if they wish, they can ink contracts that fully or partially float their electricity prices with the ebbs and flows of the energy markets.

3) *Innovation*

Competition yields innovation. We all know that. *(Slide #18)*

Electricity customer choice has stimulated a proliferation of software packages for customer to better analyze and understand the costs and uses of energy, created a variety of opportunities for customers to get paid for reducing demand during peak periods and selling the reduction back into the market as capacity.

Importantly, it must be clear that with the ongoing deployment of smart meters, the value derived from the information they generate will have more value and a wider range of uses in a customer choice environment compared to traditional monopoly. Customers can more effectively interact with a dynamic market when they have access to high quality, timely data on both the market and their own energy situation.

With the deployment of smart grid and advance meter technologies, customer choice allows for greater value to accrue to consumers, utilities and suppliers since the information they yield can be put to faster and better use.

4) *Improved Risk Allocation*

Risks should be borne by those most able to mitigate or control those risks. A key flaw in traditional monopoly utility is that the risks of business decisions can fall heavily on consumers. For example, if a monopoly utility invests in power plants that prove to operate at costs above market, consumers most likely bear all or a large portion of the above market costs of business decisions made by utility management. Further, if that plant needs to be closed for environmental or other reasons, lengthy regulatory proceedings are required and, again, customers likely have to compensate the utility.

Under customer choice, competitors bear the risks of their own business decisions. Owners of coal plants are finding that they are less able to compete with gas fired generations than they were five years ago. Yet, in customer choice states they are not able to go to regulators to ask that customer be forced to pay for their business problems.

5) *More Efficient Use of Regulatory Resources*

From my vantage point as a former utility and insurance regulator, it is my firm view that price-setting by regulators is far inferior to market determination of prices. Under conventional monopoly regulation of generation and supply prices, highly professional experts have their time consumed by tasks that can be better performed by market forces. At the same time, their professional capabilities are not put to more valuable use in financial reviews, setting of accounting standards, market monitoring, consumer protection and such critically important issues as cyber-security for critical infrastructure.

Much of traditional regulation has become a ritual with little goal other than the ritual itself. Customer choice frees high quality regulatory personnel for more substantial work.

Recommendations

Customer choice is no mystery. There is substantial experience that is entirely applicable to Michigan. Michigan is not a unique market but is part of a large electricity market consisting of the entire northeastern quadrant of the United States and parts of Canada. The only barrier to customer choice and competitive prices for electricity is Michigan's 2008 law.

My recommendation is that the Legislature should decide soon that Michigan consumers deserve access to the market. Determine that there will be a short period during which all customers will qualify for choice. Once this basic decision is made, serious discussions can begin with the state's utilities on how to address their above-market investments and costs that are reflected in Michigan's high prices. These issues have been addressed time and again in other states.

Why are Michigan's energy costs so high?

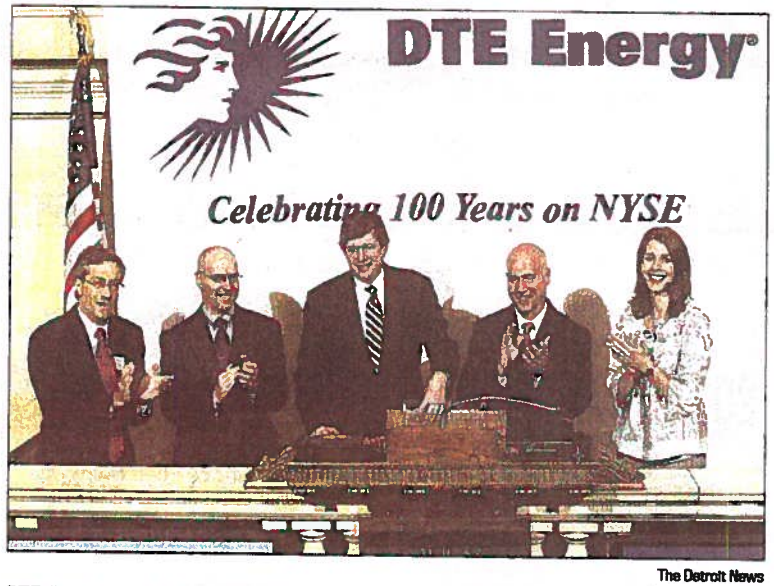
BY PHILIP R. O'CONNOR

On Monday, one of seven Michigan Energy Public Forums will take place in Detroit with the goal of gathering information to assist policymakers as they take a comprehensive look at Michigan's energy future. Michiganans, who pay the highest electricity rates in the Midwest, should welcome these discussions in hopes that the Legislature moves ahead on energy reform in 2013.

To fully understand why Michigan's energy policy needs to be revisited, it is important to examine Gov. Rick Snyder's recently asserted view that when the state revised its energy law in 2008, "we didn't realize we were on the cusp of a major economic downturn. That meant fewer factories were running machines, and fewer people were flipping light switches on. We lost about 10 percent of our electric power demand, and the remaining 90 percent had to shoulder additional costs."

If this were a medical diagnosis, the patient would be wise to get a second opinion.

Actually, Michigan's "demand destruction," as it is called in the power industry, has been in line with trends in the four other Upper Midwest industrial states of Illinois, Indiana, Ohio and Wisconsin.



The Detroit News

DTE Energy, one of Michigan's two largest utilities, is able to raise prices because customers don't have much choice when it comes to energy companies.

A decline in demand does not, however, require higher prices as suggested in Snyder's November energy message. While Michigan's average electricity rate increase of 29 percent since 2007 is not much different than the 28 percent average increase in Indiana and 22 percent average increase in Wisconsin, it is double the 14 percent average increase in Ohio and dramatically different than the 1 percent increase in Illinois. If each of these states had similar declines in demand, why have price changes been so different?

The answer is Illinois and Ohio have competitive retail electric markets. Indiana and Wisconsin have clung to traditional monopoly regulation and Michigan, in 2008, abandoned its movement toward market-based pricing in favor of government price-setting.

Millions of customers in Illinois and Ohio are taking the opportunity to choose competitive suppliers or to participate in municipal aggregation programs. They are getting the benefit of the normal functioning of a free market in which the laws of supply and demand apply. Reduced electricity demand and a flood of abundant, inexpensive natural gas have driven down prices.

Michigan's high rates are the result of the 2008 reversal of the customer choice and competition program begun in 2000. Michigan's two largest utilities, DTE Energy and Consumers Energy, were keenly aware that during an economic slowdown they would have to charge lower prices to meet the competition. Their solution was to outlaw customer choice except for a fortunate handful of customers accounting for just 10 percent of electricity usage, mainly larger businesses and government. Monopoly regulation stands the world on its head — prices rise when demand drops.

Although more than a dozen customer choice states have had abundant supplies of power, DTE and Consumers convinced policymakers that only restoration of monopoly would avoid the risk of future energy shortages. This has proven to be an expensive fiction for Michigan.

Those lucky customers allowed to contract with alternative electricity suppliers pay competitive market prices that are, on average, about 2 cents per kilowatt hour less than what's paid by the unlucky customers denied market access. The 20 percent mark-up these customers are forced to pay DTE and Consumers amounted to about $1.8 billion in 2012 alone.

As discussions around Michigan's energy future take place, the Michigan Legislature needs a clear picture of the reasons for high power prices and the magnitude of the damage to the state's economy of denying choice to customers. Michigan's deteriorating electricity price competitiveness is not fate — it is the result of a choice made on bad information in 2008.

Philip R. O'Connor is a former chairman of the Illinois Commerce Commission in the 1980s.